ETFS: UNDERLYING LIQUIDITY VS. SECONDARY MARKET LIQUIDITY EXPLAINED

Zach Hascoe — Capital Markets
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The content of this post is relevant to institutional investors interested in trading ETFs in significant size. Individual investors do not always have access to liquidity providers to trade ETFs as referenced below. We have heard it over and over: *Exchange-traded funds (ETFs) are wrappers, and the true liquidity of an ETF is derived from its underlying constituents.*[1] While that statement is true, it does not completely explain different types of liquidity that can exist in an ETF. ETFs trade on the secondary market (stock exchange) but are created and redeemed on the primary market (issuance). There is still a bit of confusion over the difference between these two markets, how they interact with each other and how investors can access liquidity via either market. Different types of ETFs can serve different purposes as exchange-traded vehicles, depending on the exposure they provide. Some ETFs are used primarily for hedging and intraday portfolio trading. These ETFs typically track major world benchmark indexes, and they trade millions of shares per day. Other ETFs are structured more as investment vehicles and don't typically have very high average daily trading volumes. Investors come into the products, hold their positions and eventually unwind the investment months or years down the road. While all ETFs can be held for prolonged periods or intraday, some ETFs experience more secondary market trading than others. At WisdomTree, we structure all our ETFs with liquidity screens to help provide sufficient implied liquidity (underlying liquidity), so even if the ETF has a low average daily volume in ETF terms, that does not mean the ETF is illiquid. A recent comparison between the WisdomTree India Earnings ETF (EPI) and the WisdomTree LargeCap Dividend ETF (DLN) helps illustrate the difference between primary market and secondary market liquidity. As the industry's first India ETF (launched in February 2008), EPI has become a popular way to gain intraday tactical exposure to India equities. For example, during the week of May 20, 2013, to May 24, 2013, EPI traded roughly $325 million of dollar trading volume on the secondary market. Yet during that week, EPI had no creation/redemption activity. There was $325 million of dollar volume traded and there were no inflows or outflows that week in EPI. That is secondary market liquidity. Investors were able to easily buy or sell EPI on the secondary market, as buy and sell orders were matched up by the broker-dealers. While new shares can be created on the primary market if demand warrants it, EPI is so widely traded by a wide variety of market participants, that often there is significant two-way trading in the ETF that happens on the exchange. At the end of the day, dealers left with inventory in EPI may decide to hold on to their positions because they are confident that two-way demand in the ETF will continue the next day. Now DLN is different and is a great example of a product that has tremendous underlying liquidity but does not trade significant volumes intraday. DLN provides exposure to the large-capitalization segment of the U.S. dividend-paying market. It has grown to a market cap of roughly $1.6 billion, but given its underlying exposure, DLN is most frequently used as a long-term investment vehicle. As a result, DLN does not typically trade significant volume intraday. Returning to the week of May 20, 2013, to May 24, 2013, DLN traded roughly $46 million in dollar notional volume for the entire week and had had roughly $15 million of inflows following a day of trading around 300,000 shares. This happens often. On a day when DLN's volume spikes, it is usually followed by a creation or redemption order. While DLN displays less secondary market trading volume in the above example, it comprises the largest divided payers in the United States, some of the most widely traded stocks in the entire world. With an implied liquidity of 6 million shares, the underlying liquidity is absolutely there for large trades—investors just have to be smart about sourcing and accessing that liquidity. To do large trades in DLN, investors typically access liquidity providers that access the liquidity in the underlying markets to provide liquidity in the ETF. To use another example, on January 29, 2013, DLN traded 2.4 million shares in one day. When large shares are traded in DLN, we typically anticipate either a large creation or large redemption order the same or the very next day. As expected, on January 30, 2013, we saw the creation of roughly $112 million of new shares. The investor utilized a liquidity provider/market maker that accessed the liquidity in the underlying market and made the client a market on the secondary market; the client traded, and ultimately new shares were created in the primary market on the back of the big trade. By understanding the difference between the primary and secondary markets, you can better appreciate the difference between trading volumes seen on the exchange and potential underlying liquidity in the ETF. A more thorough understanding of ETF liquidity also sheds light on how a certain ETF may behave in different market environments. It is important to remember that ETFs are a structure. Investors are not used to having this type of transparency in their investments. Because the ETF's components are transparent, the securities that actually define the value of the ETF will help investors understand how the ETF may act on the secondary market. In most other investment products, investors rarely ever see real-time pricing of the investment. They typically see either a daily, monthly or quarterly NAV, and they do not have to worry about the real-time pricing of the investment on a daily basis. It is important to remember that broad capital market weakness is broad capital market weakness—ETFs are not somehow immune to that. They are a wrapper that is priced via real-time calculations (if the basket is open) or via fair value models (expectations). The wrapper price is based on the underlying, ability to hedge, the cost involved in the hedge, and the costs to create/redeem. Broad, systematic weakness affects all products and structures. Understanding the primary market function can help investors understand how the ETF will behave on the secondary market during normal times, and how it may behave during times of severe market stress. **Unless otherwise noted, data source is Bloomberg.**

[1]David Abner, The Visual Guide to ETFs (John Wiley & Sons, Inc, 2013), 91

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DEFINITIONS

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Secondary market : A market where investors purchase or sell securities or assets from or to other investors, rather than from issuing companies themselves—exchanges such as the New York Stock Exchange and the NASDAQ—are secondary markets.

Primary Market : The primary market is the market where shares of an ETF are created or redeeme.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Intraday Portfolio Trading : The ability to buy or sell an ETF from anytime between the equity market open and close.

Average Daily Trading Volumes : The average amount of individual securities traded in a day or over a specified amount of time. Trading activity relates to the liquidity of a security; therefore, when average daily trading volume is high, the stock can be easily traded and has high liquidity. As a result, average daily trading volume can have an effect on the price of the security. If trading volume isn't very high, the security will tend to be less expensive because people are not as willing to buy it.

WisdomTree India Earnings Index : A fundamentally weighted Index that measures the performance of companies incorporated and traded in India that are profitable and that are eligible to be purchased by foreign investors. Companies are weighted in the Index based on their earnings in their fiscal year prior to the Index measurement date, adjusted for a factor that takes into account shares available to foreign investors.

WisdomTree LargeCap Dividend Index : Measures the performance of the 300 largest companies in the WisdomTree Dividend Index ranked by market capitalization. Weighting is by indicated cash dividends.

Dollar Trading Volume : The amount of trading within a specific timeframe expressed in U.S. Dollar.

Creation and Redemption Process : The process whereby an ETF issuer takes in and disburses baskets of assets in exchange for the issuance or removal of new ETF shares.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

U.S. Dividend-Paying Market : The market, or group, of U.S. companies that pay dividends to their shareholder.

Notional : The dollar value of the derivative contract.

Liquidity providers : Traders that facilitate the trading of ETF shares by conducting the transference of liquidity between the underlying basket shares and the ETF.

Broad Capital Market Weakness : Broad capital markets weakness is when the stock and the bond markets are feeling stress and pressure all at onc.

Real Time Calculations : A price calculation used if the basket is open to calculate the current price of a security also known as "fair value&rdquo.

Fair Value Model : A model that prices securities using eNAV, which is essentially an indicative value (IV) that is made in real time by calculating the basket value on every underlying tick and by adjustments that account for updated market news. If the basket is closed, the fair value model incorporates the closing price, currency movements and market news event to calculate a fair value for the ETF.